BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
VICTORVILLE GLASS CO., INC.)

For Appellant: John A. Strain
Attorney at Law

For Respondent: Charlotte A. Meisel
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a), of the Revenue and Taxation Code from' the action of the Franchise Tax Board in denying the claim of Victorville Glass Co., Inc., for refund of franchise tax in the amounts of **$520.06,** $1,102, and **$1,474.49** for the income years 1977, 1978, and 1979, respectively.

The sole issue to be resolved in this appeal is whether respondent correctly adjusted the additions claimed by appellant to its bad debt reserve.

Appellant, a California corporation incorporated in 1976, uses the accrual method of accounting and reports income on a calendar year basis. On its franchise tax returns it has selected the reserve method of accounting for its bad debts.

Following its incorporation in October 1976, appellant filed its franchise tax return establishing a bad debt reserve balance of $4,720. For the income years ending 1977, 1978, and 1979, appellant deducted $3,851, $8,897, and $13,086, respectively, as further additions to its bad debt reserve. These amounts represented 3.36 percent, 6.37 percent, and 7.12 percent of the trade notes and accounts receivable outstanding at the end of each of the respective years.

After respondent determined that appellant had not experienced a single bad debt during any of the years in issue or in 1976, it concluded that the amount of bad debt reserve which appellant established in 1976 was sufficient to cover the receivables originating in each of the years in issue which could reasonably be expected to become worthless. Based on the above information, respondent determined that appellant's additions to its bad debt reserve were excessive for the years 1977, 1978, and 1979, and issued proposed assessments for each of these years. After payment of the proposed-assessment, appellant filed a claim for refund which was denied and this appeal followed.

Section 24348 of the Revenue and Taxation Code provides, in part:

> There shall be allowed as a deduction debts which become worthless within the income year; or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts.

This section is derived from, and is substantially similar to, section 166 of the Internal Revenue Code. Consequently, federal precedent is persuasive in interpreting section 24348. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).)

Under the reserve method for handling bad debts, the reserve is reduced by charging against it specific bad debts which become worthless during the taxable year and is increased by crediting it with reasonable additions. In order to determine whether the amount deducted is reasonable, the test is whether the balance in the reserve at the end of the year is adequate to cover the anticipated worthlessness of the outstanding debts and not whether the proposed addition is sufficient to absorb the estimated losses. (Platt Trailer Co., Inc., 23 T.C. 1065 (1955); Black Motor Co., 41 B.T.A. 300 (1940), affd. on other issues, 125 F.2d 977 (6th Cir. 1942).) If the reserve is already adequate to cover the receivables which reasonably can be expected to become worthless, no deduction for an addition to the reserve is allowable for the taxable year. (Roanoke Vending Exchange, , 40 T.C. 735 (1963).) Primarily, the reasonableness of any addition will depend on the total amount of debts outstanding at the end of the year, including current debts as well as those of prior years, and the total amount of the existing reserve. (Former Cal. Admin. Code, tit. 18, reg. 24348(g), (repealer filed September 3, 1982, Register 82, No. 37).)

As we have noted in previous opinions, respondent's determination with respect to additions to a reserve for bad debts carries great weight because of the express discretion granted to it by statute. As a result, the'taxpayer must not only demonstrate that additions to the reserve were reasonable, but also must establish that respondent's actions in disallowing these additions were arbitrary and amounted to an abuse of discretion. (Appeal of H-B Investment, Inc., Cal. St. Bd. of Equal., June 29, 1982; Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981.)

Appellant argues that the additional amounts of bad debt reserve taken in the years at issue were justified because: (i) the economic conditions in the California real estate and construction industry were substantially poorer at the end of 1979 than in previous years: (ii) a rigid application of any accepted formula to determine the adequacy of the reserve is impossible when dealing with a relatively new business; and (iii) the list of worthless accounts written off in 1981 demonstrates the necessity of the large reserve.

In determining whether appellant's additions to its bad debt reserve were reasonable, respondent applied the six-year moving average formula set out in Black

Motor Co., supra, and approved by the United States Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 [58 L.Ed.2d 785] (1979).) The Black Motor Co. formula utilizes a taxpayer's own experience with losses in prior years and establishes a percentage level for the reserve to determine the need and amount of a current addition. After applying this formula to appellant, respondent determined that the additions to the reserve were excessive. For each of the years in issue, respondent found that appellant had not experienced a single bad debt during that year or any of the previous years of operation. As such, respondent determined that the reserve established in 1976 was sufficient to cover the receivables originating in each of these years which could reasonably be expected to become worthless.

Appellant argues that a rigid application of the Black Motor Co. formula is impossible given the fact that the six-year moving average normally used under Black Motor Co. cannot be applied here as appellant had not been in business for six years when the additions were claimed. It submits that the "flexibility" approved by the United States Supreme Court in Thor Power Tool, supra, should be recognized and that if the years 1980 and 1981 are included to establish a six-year period, it can be demonstrated that appellant began specifically to identify bad debts and to charge these against the bad debt reserve.

While we agree that the six-year moving average normally used under the Black Motor Co. formula cannot be applied here because appellant had not been in business for six years, we are convinced that it is reasonable for respondent to take appellant's past experience into account. Appellant's argument against the use of past experience centers on the fact that it is unrepresentative because of appellant's short history of operation. Appellant offers no explanation for the fact that it had no actual charge-offs for any of the years in question and 'that the amount of reserve established in 1976 was sufficient to account for bad debt losses. Appellant's history of bad debts supports the adequacy of the existing reserve and negates the necessity of any additions. (Roanoke Vending Exchange, supra.) Appellant's request that we consider later years to determine the adequacy of the reserve ignores the purpose of a bad debt reserve. A taxpayer cannot stockpile a bad debt reserve for use in subsequent years. A reserve established for such a purpose is not allowable. (Valmont Industries, Inc., 73 T.C. 1059 (1980).)

Appellant makes two other arguments on appeal. First, it argues that economic conditions were substantially poorer at the end of 1979 than in previous years, thus justifying a larger addition to the bad debt reserve. Second, it offers as evidence a list of worthless accounts which were written off in 1981 and contends that these debts originated in the years under appeal.

We find both of these argument unpersuasive. Appellant has failed to demonstrate that, even if economic conditions in the construction industry as a whole were poorer, appellant's ability to collect its receivables was affected. Finally, we find the list submitted by appellant of worthless accounts written off in 1981 to contain only one bad debt which arose in 1979 in the amount of $2,873.98. This liability was fully covered by the reserve established in 1376. The rest of the liabilities listed do not establish the necessity of the additions to the reserve claimed during each of the years at issue.

For the reasons discussed above, we conclude that appellant has failed to establish that respondent abused its statutory discretion by reducing the claimed additions to appellant's bad debt reserve for the years in question. Accordingly, respondent's action must be sustained.

Appeal of Victorville Glass Co., Inc.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good. cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Victorville Glass Co., Inc. for refund in the amounts of $520.06, $1,102, and $1,474.49 for the income years 1977, 1978, and 1979, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 26th day of October , 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

William M. Bennett, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9